Tax Matters*

November 2008

Introduction

As we near the end of 2008, we find ourselves in a position where government revenue collections are well behind target, inflationary pressures increasing and the global economy sliding into recession. All these have led to a KRA that is actively seeking collections and not necessarily with the right reasons.

This pressure on KRA to collect and at times unfamiliarity with the tax regime (never accepted in mitigation) and its ever changing legislation can result in an inability to control the costs of tax compliance and assessments for tax and penalties. The need for careful tax management is increasing and yet it is often left to remote management.

Accordingly we look in this issue at some of the issues that are giving us at PricewaterhouseCoopers sleepless nights and no doubt having the same affect on all of you! There are four particular areas that we find getting increased attention from the KRA:

- VAT on export of services
- VAT refunds
- Customs Post-clearance audits
- Transfer pricing

We also introduce you to some new senior appointments in Tax Services.

VAT and services exported out of Kenya

It is a generally accepted international principle that for VAT purposes, internationally traded services and intangibles should be taxed based on the legislation of the jurisdiction of consumption, albeit with certain exceptions. The identity and jurisdiction where the customer to which the supply is made is located is supported by the relevant business agreement, as it is expected that business agreements generally reflect the underlying transactions and financial flows. Unfortunately, this is a principle which the Treasury and KRA do not necessarily accept.

Indeed in the recent budget, we saw the introduction of the now infamous Regulation 20, which deems a service to be supplied in Kenya in most circumstances thereby ignoring the use and consumption criteria.

VAT legislation defines a service exported out of Kenya as one that is provided for use or consumption outside Kenya irrespective of where the service is performed. Our taxman's interpretation of the above provision is that if taxable services are performed in Kenya then such services are deemed to be used and consumed in Kenya and therefore subject to VAT.

KRA's views, and indeed the new regulation, are draconian and go against the Government's agenda of developing Kenya as a haven for the services industry. The whole idea behind zero-rating of exports is to give local businesses a fighting chance when competing in the global market place. Requiring business to account for VAT on services exported out of Kenya, that is for use and consumption outside Kenya, is making them uncompetitive in the global village.

Where then does that leave the confused taxpayer? In limbo would be our view. While it is our view, and we understand that legal opinion supports this, that the new regulation can only be subservient to the Act, it is clear this is not a view subscribed to by the KRA, and in some instances the Treasury, which means that businesses that export services must seek rulings from the KRA and the Treasury on a case by case basis. Any other approach will likely result in an extremely busy VAT Tribunal.

VAT refunds – Taxpayer paying through the nose

With the ever increasing cost of doing business and in particular cost of financing, businesses in a VAT refund position find themselves having to borrow money from financial institutions at high interest rates and then 'lending' it to the Government for free. This indeed has been the issue with VAT refunds from the KRA that continues to plague the business community.

In the recent past we witnessed the introduction of withholding VAT which was a two edged sword. While it widened the VAT net by roping in rogue businesses, it also turned some businesses which were traditionally in a VAT payable position into a VAT refund position. Even though the law has been amended to allow taxpayers in a VAT refund position because of withholding VAT to apply for exemption, the discretion has been has been left solely to the KRA.

Matters were made worse by removing the opportunity for businesses to reclaim excess input VAT that arises on capital investments. The amendment in the Finance Bill means that businesses in a traditionally VAT payable position will not be eligible to claim VAT refund as a result of capital expenditure. Such taxpayers will be expected to pay the VAT at the time of investment and then carry forward their VAT credit and utilise it against future VAT liabilities. This will have significant cash-flow implications for such businesses. The alternative would be an application for VAT remission - a torturous route that does not always succeed. However, where you are making significant capital investment and are generally in a VAT refundable position, this would seem to be the only alternative. Until we are allowed as a matter of course to offset overpayment from one tax against another, there seems to be little alternative.

In all the doom and gloom over VAT refunds, there may be one ray of sunshine. His Excellency the President recently instructed the KRA to make all outstanding VAT refunds within 60 days of the date of his pronouncement – 6 October 2008. A brilliant notion but where, one must ask, does KRA get the Kshs 10 billion that is thought to be required to carry out this directive? Back to the doom & gloom it seems!

Customs Post-Clearance Audits

As the role of customs becomes increasingly focused on facilitating the movement of goods to support an ever-burgeoning volume of international trade, the task of customs control has made a marked shift away from physical verification at entry points to control methods that are targeted at the pre-clearance and post-clearance stages. Customs post-clearance audits (PCA) represents one of the most effective measures for preventing and detecting commercial fraud, particularly valuation fraud, in addition to any other customs transgressions e.g. tariff misclassification.

As with other revenue authorities, KRA is increasingly carrying out PCAs. A warning - in performing a PCA, KRA often use it as an opportunity to carry out a comprehensive audit of all taxes.

Quite often the clearance of imported goods and the payment of the associated import duties are left to remote management. Generally, the activity is left to freight forwarders, agents or other third parties and while it is not suggested that this be changed, business needs to be aware that PCA can and will often result in significant penalties if care is not taken.

The complexity of customs legislation and regulations makes PCA a ripe area for KRA to concentrate on. There can be little doubt that with the amount of remote management in this area, KRA will in all likelihood find some way to bridge the revenues gap with PCA.

PCA is intended to ensure that you are complying and it is here to stay and will be used by KRA to meet its collection targets. Are you prepared for a customs post-clearance audit?

Transfer Pricing – the next big area of attack?

Although KRA has not been particularly successful to date in respect of making significant transfer pricing adjustments it is not for a lack of trying. It now appears that KRA may follow the tradition of other revenue authorities in the world and start its audit activities by challenging the soft underbelly of transfer pricing – services. The KRA appears to have the perception that Kenyan companies have double standards – from its perspective they appear to be quick to deduct costs for services received but slow to charge out costs in respect of services rendered.

Nairobi now hosts a number of regional headquarters or shared service centres for multinational companies and the costs incurred by these multinational companies should be charged out to the recipients of the regional or shared services in an arms length environment.

There is a general reluctance amongst Kenyan companies to charge out the costs of these services due to the plethora of regional transaction taxes such as reverse charge VAT and withholding tax which may end up being unrecoverable. However in an arm's length situation, such costs should be charged out and ideally with a profit element. The make up and allocation of the costs may result in a complex exercise where multiple jurisdictions are involved to ensure that no one party to the transaction is inappropriately charged for the services received.

The KRA are unsympathetic to arguments against charging out such costs especially where it stands to gain considerable revenue when one multiplies the costs over a 7 year period.

We are witnessing a KRA that is becoming increasingly more sophisticated in raising transfer pricing queries in relation to the charges that Kenyan companies receive in respect of services provided by related parties from overseas. It is imperative that Kenyan companies ensure that these service fees are thoroughly analysed and documented on a continuous basis.

There can be no doubt that a revenue embattled KRA is actively looking for easy pickings. This is one of them and while they are scrutinising services charges currently, it won't be long before inter-company trade reappears on the radar. Another case of being forewarned is to be forearmed!

Some other developments

Low income housing VAT relief: The Government has finally backed its promise with action by gazetting the long awaited VAT incentives aimed at luring property developers into the low cost housing market. The regulations which took effect on 2 September 2008 provide for VAT remission on taxable goods and services to developers who are putting up low income housing.

A welcome reduction – power bills going down: From 31 October 2008 the rate of VAT is 12% rather than 16% for diesel oil, residual fuel oils and electrical energy. One hopes that this will bring some relief to beleaguered industries not to mention our home electricity bills.

Who goes into the port: it seems that KRA and the KPA have decided that one way to ease congestion at the port is to exclude clearing agents from entry. It remains to be seen how this will impact on business trying to clear their goods, but it can also be seen as a step towards full use by KRA of post clearance audits!

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Nikhil Hira - Director

Nikhil Hira has joined PricewaterhouseCoopers Kenya as a Director in the Tax practice. An experienced tax specialist, Nikhil's immediate focus will be on advising clients on Indirect Tax matters and delivering Direct Tax services.

Nikhil rejoins professional practice after several years in commerce. He has had previous experience at PricewaterhouseCoopers legacy firms, other professional firms and in global and local industry. One of his major highlights was developing an Indirect Tax practice in East Africa specialising in value added tax and excise duties.

He has been an active member of the Council of the Institute of Certified Public Accountants of Kenya – particularly of its Public Finance and Professional Standards committees. He was also a regular public commentator on topical tax matters and was instrumental in establishing the current regime of VAT refund audits by professional firms. He holds BSc joint honors in Accountancy and Process Engineering and is a member of ICPAK Kenya, Uganda and Tanzania.

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Titus Mukora - Senior manager

Titus Mukora is a Senior Manager – Transfer Pricing in PricewaterhouseCoopers, Kenya and a member of the transfer pricing team. He has over 9 years of professional experience gained in law, tax and transfer pricing. Titus spent 3 years with the transfer pricing team of PricewaterhouseCoopers South Africa in the Johannesburg office. In South Africa, he was involved in documentation and planning studies for some of South Africa's biggest mining and oil companies and manufacturers. After South Africa, Titus worked for 2 years with KPMG Australia in the Sydney office specialising in transfer pricing. He was mainly involved with transfer pricing planning studies. Some of the projects he undertook for a client undertook included business restructuring projects including the relocation of functions and risks and preparation of defence documentation for a global profit sharing arrangement.

Titus holds a Bachelor of Law from London School of Economics. He is an Advocate of the High Court of Kenya.

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Thomas Murega - Manager

Thomas Murega is a manager in our Direct Tax Team in PricewaterhouseCoopers Kenya. He has over 5 years of professional experience in advising local and international companies in various sectors on various direct tax issues. Prior to joining PricewaterhouseCoopers in 2002, he briefly worked for a local downstream oil with both local and international operations. He recently returned to the Kenya Office after completing his secondment to PricewaterhouseCoopers – Ghana.

Thomas has considerable experience in general corporate taxation of multinational and local companies. These experiences include annual corporate tax compliance, ad hoc tax advice and assisting with Revenue Authority queries, tax audits and investigations including preparation of appeals and other submissions to the Revenue Authority. He has been involved in various assignments for clients in the oil & energy, financial services, telecommunications and manufacturing sectors.

Thomas holds a Bachelor of Commerce – Accounting from Kenyatta University. He is a qualified Certified Public Accountant and a member of Institute of Certified Public Accountants of Kenya (ICPAK).He is also currently pursuing an MBA at the University of Leipzig, Germany.

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